

QUARTERLY
COMMENTARY

A quarterly commentary on the markets and the economy from Rorer Asset Management, LLC

LARGE CAP RELATIVE VALUE EQUITY:

10 LARGEST HOLDINGS AS OF
SEPTEMBER 30, 2004

Abbott Labs (ABT)
CVS Corp. (CVS)
Goldman Sachs Group, Inc. (GS)
Hewlett-Packard Co. (HPQ)
J.P. Morgan Chase & Co. (JPM)
Lowe's Co. (LOW)
Marsh & McLennan (MMC)
Quest Diagnostics, Inc. (DGX)
United Technologies Corp. (UTX)
US Bancorp (USB)

MID CAP RELATIVE VALUE EQUITY:

10 LARGEST HOLDINGS AS OF
SEPTEMBER 30, 2004

Aon Corp. (AOC)
BJ's Wholesale Club, Inc. (BJ)
Bear Stearns Cos., Inc. (BSC)
Constellation Energy Group (CEG)
Loews Corp. (LTR)
Navistar Int'l Corp. (NAV)
Newfield Exploration Co. (NFX)
Norfolk Southern Corp. (NSC)
Quest Diagnostics, Inc. (DGX)
Tellabs, Inc. (TLAB)

RORER
ASSET MANAGEMENT, LLC

THE RORER REVIEW

THE GOLDBLOCKS ECONOMY

In the last issue of the Rorer Review, entitled "Temporary Inflation," we examined the inflationary pressures that had arisen in mid-2004, and our thesis that those pricing pressures would prove to be temporary thanks to an economic slowdown in China and a lack of wage pressure in the U.S. Since that time, inflationary pressures have indeed subsided. In fact, the financial press is full of anecdotal evidence that sustained upward pricing pressure is unlikely. In September alone, two consumer bellwethers, Coca-Cola Company and Colgate-Palmolive announced earnings disappointments due to pricing pressures on their products.

In the past three months, we have also seen a slowdown in the pace of economic growth in the U.S. This was not totally unexpected. After all, the economy grew at a fairly robust rate for much of the past two years, and it is typical to settle down to a more sustainable rate of growth later in the economic cycle. However, higher energy prices have also acted as a drag on economic growth both here and abroad.

The concern of the day is that spiking oil prices will choke off the economic expansion and lead to the next recession. This kind of thinking has resulted in a tough stock market environment for most of 2004. In fact, the market leaders of this year, apart from the Energy sector which has done well in conjunction with the rise in its main commodity, have been the likes of Utilities and Healthcare. These sectors typically outperform when investors are worried about the sustainability of an economic expansion.

We believe the concerns of a recession will prove to be overblown. In fact, we think the current forces at work, higher oil prices and slightly higher interest rates versus robust growth in Asia and record corporate

profitability in the U.S. and abroad, have set us up for a Goldilocks scenario where economic growth is neither too strong nor too weak, but just right.

In this issue of the Rorer Review we will explore rising energy prices and their affect on the consumer and corporate America. We will conclude with a look at the stock market and our view that the worries of the past several months, and perhaps years, have gotten us to a particularly attractive point for investors.

EFFECTS OF RISING OIL PRICES

The biggest stumbling block to continued economic growth, in the opinion of many, is the rising price of oil. Higher energy prices adversely affect everyone, from the manufacturer to the consumer. On the consumer side, the reasoning goes that higher priced oil leads to higher fuel costs, which acts as a tax against discretionary spending.

While we by no means regard this "tax" as inconsequential, we believe the consumer will continue to fare quite well. For starters, the unemployment rate is currently at an historically low level of 5.4%. Said another way, roughly 95% of those that want to work are currently employed. The icing on this cake is the recent Chicago Fed report which came to the conclusion that "jobs paying better than the mean" are outstripping the creation of those at the bottom end. Given all this, it appears that the consumer should remain healthy for the foreseeable future.

There is also the fear that higher energy prices will lead to reduced corporate profitability down the road. After all, it is well known that past spikes in the price of oil, such as those of 1990 and 2001, led to recessions. In our opinion, there are meaningful differences between those times and today. One thing all three time peri-

ods have in common, however, is that the Federal Reserve was and is in the process of raising interest rates. To stop the analysis there, however, would be to ignore some important differences. In 1990, while oil prices rose, the fed funds rate was up 3.25% to a very economically restrictive 9.75%. Similarly, by 2001, rates had risen 1.75% to 6.5%. So far, in the current cycle, the Fed has raised interest rates only 0.75% to a still accommodative 1.75%.

To be sure, we expect rates will head higher from here. Historically, the Fed has aimed for real rates, the fed funds rate minus the rate of inflation, of 1.5%. If one assumes the current inflation rate to be approximately 1.5%, then today's rate of 1.75% falls well short of this average. The Fed could raise interest rates another 125 basis points and still have a relatively accommodative stance by historic norms!

By all outward appearances, corporate America is not worried about an oil led recession. Despite robust corporate profitability in 2004, total bank loans are set to rise at an 11% rate for the full year. This number includes an increase in corporate and industrial loans, which had been in a steady down trend until May of 2004. This money has been put to work to build inventory and increase levels of spending on capital equipment. Both of these events are signs of increased confidence in the future.

All of this is not to say that high and rising oil prices are of no concern. Indeed, estimates have it that economic growth, as measured by GDP, is slowed by 0.5% for each \$10 increase in the price of oil. So, an oil price that has risen approximately \$18 per barrel thus far in 2004 has certainly been at least partly responsible for slower growth in the latter part of 2004.

One must, however, keep in perspective the part oil plays in our economy and on inflation. As the U.S. has drifted more toward a service economy over the years, spending on energy has declined significantly to a point where

it now accounts for just 3% of GDP. Meanwhile, global competition and technological advancement is helping to keep the Consumer Price Index (CPI) at low levels. Items within the CPI that are U.S. centric, such as healthcare, entertainment and lodging have been moving to the upside. However, within the CPI there are numerous factors whose prices are subject to stiff international competition. For the twelve months ending this past August, the price of personal computers is down roughly 10%. The cost of apparel, new and used cars and personal care products also declined during this period. Thanks to new technologies, such as Voice Over Internet Protocol (VOIP) phone service, the price of telecommunications is declining as quality improves.

The bond market is certainly not worried about inflation. In fact, while the Federal Reserve has been raising rates and the price of oil has been climbing steadily, the 10-year bond yield has actually *fallen* from a near term high of 4.8% to about 4.1% today. The bond market is telling us that inflation is not even on the radar. Furthermore, even with fed funds likely to increase to the 3.0%+ area over the next several quarters, we do not believe that the 10-year bond yield will rise appreciably given the checks and balances present in today's economy. This truly is a Goldilocks scenario.

THE MARKETS

As we noted at the beginning of this Rorer Review, the performance of the equity markets thus far in 2004 has reflected a growing concern about the sustainability of the current economic expansion. Taking a somewhat longer view, the S&P 500, at 1130, is at roughly the same level it achieved in the second quarter of 1998. In that same time frame, the fed funds rate has fallen from 5.5% to 1.75% today. The yield on the 10-year bond has fallen to roughly 4% from 5.5% in 1998. Further, economic growth here and

abroad has produced earnings for the S&P 500 that are 45% higher today than they were six years ago.

We think one would have to assume a substantial deterioration in earnings from here to make these levels sustainable. Rather, we expect that the economy and earnings will continue to march ahead for the next several quarters, if not years, and consequently we find today's market valuations to be very attractive. Furthermore, we think the best returns in the equity markets will come in the least risky area: large capitalization stocks. Today, these companies, which arguably are the best positioned to benefit from the global growth of the future, are among the least expensive. In fact, based upon estimates of earnings for the next twelve months, the S&P 500 Index, which consists of the largest companies trading in the U.S. markets, is selling at a price/earnings discount to the S&P 600, its small capitalization equivalent. Historically, the premium would be accorded to the larger companies given their lower risk profile, steady growth prospects and their proclivity to distribute some of their earnings to shareholders in the form of dividends. We expect that this will again be true in the future, and that the larger capitalization stocks will outperform their counterparts going forward.

At Rorer Asset Management, our goal has always been, and continues to be, to invest in the highest quality companies available at the most attractive prices. By strictly adhering to our time proven disciplines, we are confident that our clients will be the beneficiaries of improved relative valuations in the high quality securities currently residing in their portfolios.

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